

VZCZCXRO5542

PP RUEHAO RUEHCD RUEHGA RUEHGD RUEHHA RUEHHO RUEHMC RUEHNG RUEHNL
RUEHQU RUEHRD RUEHRG RUEHRS RUEHTM RUEHVC
DE RUEHBR #0876/01 1251320
ZNY CCCCC ZZH
P 051320Z MAY 06
FM AMEMBASSY BRASILIA
TO RUEHC/SECSTATE WASHDC PRIORITY 5294
INFO RUEHWH/WESTERN HEMISPHERIC AFFAIRS DIPL POSTS PRIORITY
RHEHNSC/NSC WASHDC PRIORITY
RUEATRS/DEPT OF TREASURY WASHINGTON DC
RHEBAAA/USDOE WASHDC
RUEHC/USDOC WASHDC

C O N F I D E N T I A L SECTION 01 OF 04 BRASILIA 000876

SIPDIS

SIPDIS

STATE PASS TO USTR FOR MSULLIVAN/KLEZNY
NSC FOR SUE CRONIN
DEPT OF TREASURY FOR FPARODI
AID/W FOR LAC/AA
USDOC FOR 4332/ITA/MAC/WH/OLAC/JANDERSEN/ADRISCOLL/MWAR D
USDOC FOR 3134 USFCS/OIO/SHUPKA
USDOE FOR GWARD/SLADISLAW

C O R R E C T E D COPY (Class Authority)

E.O. 12958: DECL:05/02/2016

TAGS: [EINV](#) [PREL](#) [EPET](#) [XM](#) [BR](#)

SUBJECT: BRAZIL - UNCERTAIN RESPONSE TO BOLIVIAN OIL AND GAS
NATIONALIZATION - Corrected Copy

REF: A) LA PAZ 1157
B) BRASILIA 142
C) BRASILIA 754
D) BRASILIA 799
E) BRASILIA 848
F) BRASILIA 855
G) BRASILIA - WHA EMAIL 2 MAY 2006
H) 2005 BRASILIA 3305
I) SAO PAULO 464

Classified by Charge d'Affaires Phillip T. Chicola, Reasons 1.4
(b) and (d).

¶1. (C) Summary: After an emergency cabinet meeting lasting into the evening to discuss the appropriate Brazilian response to Bolivia's May 1 nationalization of foreign oil and gas investments (ref A), the Lula Administration issued a stunningly bland public statement the evening of May 2 recognizing Bolivia's sovereignty to act as it did but reaffirming that the GOB would act to protect the interests of (partially-privatized parastatal) Petrobras. According to local media, President Lula will meet his counterparts from Argentina, Bolivia and Venezuela on May 4 in Puerto Iguazu, Argentina to discuss the situation. In contrast to the Lula administration's feeble public stance, Brazilian media commentary has been sharp, decrying Bolivia's use of troops to occupy oil and gas installations; some have called for Brazil to withdraw its Ambassador to Bolivia (ref F). Although Petrobras may resort to arbitration to protect the approximately US\$1.6 billion it has invested in Bolivia, this amount represents only about 2% of Petrobras' worldwide investments. Given that Bolivian gas makes up only 4% of Brazil's overall energy consumption, most analysts foresee limited impacts even if the gas supply were to be interrupted. End Summary.

Bending to Evo's Will?

¶2. (SBU) The GOB's formal reaction to the nationalization operation finally emerged early on the evening of 2 May, after marathon meetings chaired by Lula that began at 11:00 am and extended throughout the day. The stunningly brief and anodyne presidential press release-- the insipid fruit of an entire day

of Lula-led crisis-mode deliberations for which two cabinet ministers had been called back to Brasilia from abroad -- consisted of only five points in which the GOB recognized Bolivia's right to "nationalize the riches of its soil and control their industrialization, transport and commercialization," affirmed the GOB will act "with firmness and tranquility in all fora" to preserve Petrobras' rights and carry out mutually beneficial negotiations with Bolivia, and assured that supplies of natural gas to Brazil are guaranteed by the will of both countries, as reiterated in a telephone conversation between Morales and Lula (presumably on 2 May).

13. (SBU) The tepid reaction from the presidency -- despite expectations from senior GOB advisors that Lula would have to make some strong point of protest (see below) -- may well fuel criticisms in the opposition and media that the GOB's policy toward Morales has been shown to be disastrously inept. The announcement that Lula will go Argentina this week to meet Morales and Venezuelan President Hugo Chavez -- who is now widely considered in Brazil to be the guarantor of Morales' bold action -- may further reinforce the negative impressions of a president caught asleep at the switch and unwilling to stand up forcefully for vital Brazilian interests. Foreign policy is seldom a major issue in Brazilian presidential campaigns, but it is a certainty that this episode will feature prominently in the opposition's campaign.

14. (C) In a private meeting with Emboff on 2 May (ref G), Marcel Biato, Lula's deputy foreign affairs advisor, provided insight on the thinking within Lula's inner circle on the day after Morales made his move. The GOB was not surprised by the content of the nationalization decree -- those are the uncompromising terms Brazilian negotiators have been hearing for the past 7-10 days. Biato said that in March, Petrobras and Bolivian interlocutors had been engaged in what appeared to be

BRASILIA 00000876 002 OF 004

relatively positive discussions. However, Morales abruptly broke the talks off, insisted he would only discuss the issues with Lula directly, and the Bolivians only re-engaged in recent days, with the stark message they took public on 1 May. In the interval between the March talks and the nationalization, Biato observed there was a lot of Morales interaction with Chavez. (Note: Per ref D, Chavez and Lula met in Brasilia on 20 April; in the meeting Lula was to register his concern about the nature of Venezuelan involvement with Morales on the hydrocarbons issues. End note.) It is clear now to the GOB that Morales was emboldened after hearing that Chavez would (a) provide technical help to get gas out of the ground if Petrobras bails (which the GOB doubts the Venezuelans have the know-how to do), and (b) buy the product. (Comment: This view has now taken hold in the Brazilian media and opposition as well. End comment.)

15. (C) While not surprised by the terms of yesterday's decree, the timing, lack of diplomatic notice and use of the armed forces (presumably for dramatic impact in Bolivia and to show the military's solidarity with Morales in the action, Biato opined) angered the GOB, who anticipated that early Brazilian references to the action as "unfriendly" would be echoed by Lula in his statement. Biato noted there is a domestic requirement that Lula "say something tough" now at a political level, though the GOB wants to avoid turning this into a Morales-Lula slugfest. (Comment: Biato was wrong -- the anemic presidential statement contains no hint of criticism or official displeasure. End comment.) As talks proceed over the next six months, Biato said options available to Brazil include: (1) Petrobras operates but prepares to break contractual obligations (e.g., non-payment to Bolivia, with the line that Morales can just deduct what he wants from Bolivia's debts to Petrobras). GOB would prefer not to compromise its legal standing by breaking a contract, however, Biato said; (2) Petrobras prepares to pull out unilaterally; (3) Petrobras starts arbitration. The latter course looks most likely at this point, Biato said (but see below).

16. (C) However, Petrobras will not/not accept a massive price

increase under any circumstances, and will also not accept a role as just a service provider, Biato confirmed. Those are red lines for both the company and the GOB, as Morales has been told repeatedly. In that sense, Biato said "this is a poker game," where Brazil's interests are big, but Bolivia's potential for loss is much bigger. But in poker, as in diplomatic negotiations, the players must have some sense that their opponents are operating from a base of logic and rationality. At this point, the GOB's senior level has lost confidence that Morales possesses those qualities, Biato said. There is a sense in the GOB that Morales, "just put this out there, did what he wanted to for his own political reasons, and now expects all the rest of us to sort it out," Biato said. Again, the influence of Chavez must come to mind, Biato acknowledged.

Petrobras: Evo Engaging in "Scare Tactics"

17. (SBU) Despite Petrobras President Sergio Gabrielli's previous public statements that it would leave Bolivia rather than accept nationalization or become simply a service provider, after the occupation of its oil and gas facilities by Bolivian troops Petrobras has hewn to the Lula administration's bland 2 May public response. A Brasilia-based Petrobras contact told us the company's strategy after the statement is to let this issue remain at the government-to-government level. Petrobras employees have essentially been told to stay put, shut up, keep their heads down, and let the Brazilian government negotiate with the Bolivian government. According to our Petrobras contact, the company regards the timing and drama of the action primarily as a negotiating tactic. The slow and contentious contract renegotiations, the pipeline break of last month and the ongoing repairs have obviously called into question Bolivia's position as a stable supplier for the Brazilian gas market. The threat of nationalization is meant, he said, to scare Petrobras and others back to the negotiating table and make them more willing to accept Bolivian government terms.

Short Term Bolivia Risk Already Figures In

BRASILIA 00000876 003 OF 004

18. (SBU) A number of contacts have told Econoffs that financial markets already had factored in substantial Bolivia risk into Petrobras' share price and expect little disruption in the short term. Roberto Troster, the Chief Economist at FEBRABAN (the Brazilian banking industry association) said that financial circles are in a "wait and see" mode, since there does not appear to be a threat that gas supplies will be cut in the near term and because Bolivia is such a small percentage of Petrobras assets. Likewise, a Banco Pactual analyst saw limited effects on Petrobras in the short term as Bolivia accounts for less than 3 percent of the company's oil and gas production and about 2 percent of Petrobras' US\$66 billion assets. Petrobras shares, which opened on the NYSE May 2 with a small drop, made up the lost ground and closed up overall.

Limited Economic Impact foreseen

19. (SBU) While gas from Bolivia is 43-44 percent of the natural gas consumed in Brazil, it makes up only about four percent of Brazil's total energy consumption. Gas is used principally for cooking, gas-fueled cars and buses, industry (iron and steel, chemical, ceramics, glass) and power generation. A Petrobras contact told post that the company's contingency plan in the event of a gas shortfall is to cutback on gas-fired electricity generation plants to preserve supply for other uses. Brazil is in a good position to do so as currently the reservoirs at Brazil's hydroelectric power plants, which make up well over 80% of Brazil's power generation capacity, are at high levels. This will preserve scarcer gas supplies for industrial uses (which generate employment), as well as domestic and transportation uses. A May 2 Credit Suisse First Boston report estimated that the inflationary and growth impact of the nationalization (or

any reduction in supplies from Bolivia) will be low based on the availability of hydroelectric power to supply energy demands.

Medium to Long Term Alternatives

¶10. (SBU) Brazil recently had dusted off its contingency plans to deal with gas supply shortfalls after the Bolivia pipeline was damaged by recent rains (ref C). Local analysts also have pointed out that Brazil has alternatives in the longer term, as development of the offshore Santos basin will provide a new domestic gas source to rival the size of current Bolivian supply in the 2010 to 2012 time frame (ref I). In the medium term, however, Brazil could face a crunch, as expected power demand is projected to exceed projected capacity in the 2009 time-frame. Removing the gas-fired thermal generation plants from the power mix likely would bring forward the moment when Brazil faces power generation shortfalls. Industry contacts have told us that the gas-fired electricity generation plants (many of which are presently idle as hydro power is cheaper) could be converted to diesel or oil to help deal with the situation. The process, however, would take some time and would be expensive (ref H). Separately, Petrobras is examining the feasibility of building two Liquid Natural Gas (LNG) re-gasification plants, reportedly at a cost of about US\$400 million each, to allow gas imports from countries such as Nigeria and Algeria.

Comment

¶11. (C) On the political level, Lula and his foreign policy team could not look worse at this moment. The image of Bolivian soldiers moving into Petrobras installations is vivid and offensive for Brazilians of all classes, and will appear to many as a massive rebuke to the Lula administration's theology of a Brazilian-led new era of "regional integration." Indeed, in the Brazilian press and popular imagination, Lula is increasingly seen as outmaneuvered, manipulated and flim-flammed by his "hermanos," Chavez and Morales. The PSDB opposition and much of the media can be counted on to keep this episode alive, pointing it out as another defeat for Lula's foreign policy, and blistering evidence that the ideological bias and operational incompetence of Lula's government can place key Brazilian

BRASILIA 00000876 004 OF 004

national interests in peril.

¶12. (C) On the economic front, Brazil is likely far less vulnerable to serious immediate damage from Morales' May 1 nationalization decree than the headlines suggest. Although there is clear potential for a medium term energy crunch and certain gas-consuming Brazilian industry may be hurt, the GOB has the luxury of time and resources to work on alternatives. This makes Lula's weak-kneed response to the spectacle of Bolivian troops occupying Petrobras' facilities -- which itself followed on the heels of Morales' expulsion last week of Brazilian steel company EBX -- all the more puzzling. Although Petrobras may nevertheless ultimately seek arbitration, depending on the evolution of events, it will be much harder for it to do so without more energetic GOB backing.

CHICOLA